M E M O R A N D U M

To: Directors of Public Company Licensees **Date:** December 31, 2002

Subject: Compliance with the California Corporate Disclosure Act and the Sarbanes-Oxley Act of 2002

From: Donald R. Meyer, Commissioner of Financial Institutions

The purpose of this memorandum is to provide a summary of some of the new provisions of federal and state laws relating to corporate governance which may apply to some licensees. The California Corporate Disclosure Act and the Sarbanes-Oxley Act of 2002 ("Act") apply to public companies. There are exceptions to the applicability of the Act and the Act may not apply to licensees which are not public companies or which have holding companies. However, even though the licensee may not be subject to the Act, its holding company may be subject to it. Therefore, it is suggested that each licensee confer with its legal counsel regarding the application of the Act to the licensee or to its holding company.

I California Corporate Disclosure Act

The California Corporate Disclosure Act, effective January 1, 2003, amends Sections 1502 and 2117, and adds Section 1502.5 to, the Corporations Code (Stats. 2002, ch. 1015). The new state law requires additional public disclosures by "publicly traded companies, "including domestic and foreign corporations, qualified to transact intrastate business in California. The purpose of the new required disclosures is to help combat fraud and protect investors. "Publicly traded company" means a company with securities listed or admitted to trading on a national or foreign exchange, or which is the subject of two-way quotations that are regularly published. Such companies must file with the Secretary of State a statement, in the form prescribed, including the following additional information:

- Name of independent auditor, description of other services provided as specified, and date of the last audit, including a copy of the report;
- Annual compensation paid to each director and executive officer;
- Description of any loans made to any director at a preferential loan rate;
- Statement indicating whether any bankruptcy has been filed by corporation executive officers or directors during the past 10 years;
- Statement indicating whether any member of the board of directors or executive officer of the corporation was convicted of fraud during the previous 10 years;
- Statement indicating whether the corporation violated any federal security laws or any **banking** or security provisions of California law during the previous 10 years for which the corporation was found liable in an action before a federal or state court or regulatory agency or a self-regulatory agency in which a judgment over $10,000 was entered.

II Sarbanes-Oxley Act of 2002

The provisions of the Act became effective on July 30, 2002. The purpose of this legislation includes protection of investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and is "intended to address the systemic and structural weaknesses affecting our capital markets as revealed by the repeated failures of audit effectiveness and corporate and financial and broker-dealer

responsibility in recent months and years." [1] The Act is said to effect the most extensive reforms in American business practices since the Great Depression and enactments of the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). The Act provides a legislative response to the problems of Enron, Global Crossing, World Com, other cases of corporate malfeasance, and attempts to restore confidence in our capital markets.

Application, Administration and Enforcement

The Act applies to **"**issuers,**"** as defined in the Act, which includes all SEC-reporting companies, domestic or foreign. Section 2 (a). Such public companies include banks and bank holding companies but exclude banks which are wholly-owned subsidiaries of bank holding companies, or other wholly-owned affiliates of banks or bank holding companies. The Act also amended Section 12(i) of the Exchange Act to make it clear that the federal banking agencies have the authority to administer and enforce various provisions of the Act applicable to banks which are public companies, specifically, Sections 302, 303, 304, 306, 401(b), 404, 406, and 407. Section 335.101 of the FDIC Regulations (12 C.F.R § 335.101) incorporates through cross reference the regulations of the Securities and Exchange Commission ("SEC") issued under specified sections of the Exchange Act. The Federal Reserve Board's Regulation H has also been amended to require registered member banks to comply with any rules the SEC adopts under Section 10A(m) of the Exchange Act (added by Section 301 of the Act), or Sections 302, 303, 304, 306(a), 401(b), 404, 406, and 407 of the Act. Some of the provisions of the Act are effective immediately, but most provisions require rulemaking by the SEC. The SEC must propose and adopt final rules for implementation of various provisions of the Act by the deadlines specified in the Act. The following is an overview of certain sections of the Act which relate to or are applicable to state-chartered banks which are public companies.

Public Accounting Oversight Board. **Sections 101-109**. The Act seeks to reform the accounting profession by establishing the Public Company Oversight Board, a self-regulatory, nonprofit corporation subject to SEC oversight ("Board"). The Board is responsible for overseeing the audits and auditors of public companies and participates in the establishment of auditing standards relating to the preparation of audit reports for issuers. The Board is to be fully organized by April 26, 2003.

Public Company Audit Committees. Section 301. Each board of an insured bank (or its holding company) which is a public company must comply with the additional requirements of Section 301, as well as continue to comply with the existing financial management requirements of the Federal Deposit Insurance Act. 12 U.S. C. § 1831(m). The SEC must adopt rules directing the national security exchanges and the National Association of Securities Dealers to prohibit listing any company that does not satisfy the audit committee requirements in Section 301. The audit committee must be composed of entirely "independent" directors as defined in the Act. "Independence" is defined to prohibit the director's acceptance of any consulting, advisory or other compensatory fees from the issuer and being an affiliate of the issuer, or any subsidiary, thereof, subject to the exemption authority of the SEC and federal banking agencies. The audit committee is directly responsible for the appointment, compensation, and oversight of any registered public accounting firm engaged by the issuer. Each audit committee has the authority to engage independent counsel and other advisors. This new authority under the Act is similar to the existing authority of "large bank" audit committees, as defined by the FDIC, to have access to its own outside counsel. 12 U.S.C. § 1831 (g)(1)(C)(ii). The SEC must adopt final rules for implementation of Section 301 by April 26, 2003. The SEC must also issue rules requiring **disclosure** of

[1] Report of the Committee on Banking, Housing, and Urban Affairs on the Public Company Accounting Reform and Investor Protection Act of 2002, at 1. The bill was enacted as the Sarbanes-Oxley Act of 2002, Pub. L. No 107-204, 116 Stat.745 (2002).

whether an issuer's audit committee includes at least one **"financial expert,"** with auditing experience and knowledge of GAAP, as defined in the Act. **Section 407.**

Loans to Executive Officers and Directors. The ban on loans to executive officers and directors in Section 402 does not apply to an issuer that is an insured depositary institution, as defined in the Federal Deposit Insurance Act, if the loan is subject to the requirements of the insider lending restrictions of Section 22(h) of the Federal Reserve Act and the Federal Reserve Board's Regulation O. California state insured non-member banks, including public companies, are subject to the lending restriction of Regulation O of the Federal Reserve Board pursuant to both Section 337.3 of the FDIC Regulations and Financial Code Section 3370 et seq. These authorities provide ample support for the statement that insured banks are subject to the lending restrictions of Section 22(h) of the Federal Reserve Act (Regulation O), and, therefore, are not subject to Section 402 of the Act (ban on loans to insiders). While insured banks are not subject to Section 402, **independent state-chartered trust companies which are not "insured depositary institutions" but are public companies may be subject to the prohibitions contained in Section 402.**

Corporate Responsibility for Financial Reports. Sections 302 and 906. SEC Order 4-460 required a "one time" certification from the 947 largest public companies, compelling the CEOs and CFOs to certify to the accuracy of disclosures when the next quarterly report was required to be filed. There are also two apparently divergent certification requirements contained in **Section 302** and **Section 906**, each requiring the CEOs and CFOs of public companies to certify that the financial statements contained in the company's periodic reports fairly present in all material respects the financial condition and results of operations of the company, as well as certification of other matters as required by each section. **A "knowing" and "willful" failure to comport with the requirements of Section 906 results in criminal penalties.** Section 906 is effective immediately. **Section 302** also requires a **company's** CEO and CFO to certify that the periodic report(s) do not contain any untrue statement of a material fact or material omission, as well as other matters. Section 302 has been implemented by SEC Rules 13a-14 and 15d-14. Reporting companies, foreign private issuers, and voluntary filers are all subject to the certification requirements of Section 302.

Improper Influence on Audits. Section 303. The Act makes it illegal for a company's directors or officers to "fraudulently influence, coerce, manipulate, or mislead" an accountant for the purpose of rendering the company's audit report materially misleading. The SEC must adopt final rules by April 26, 2003.

CEO and CFO Forfeiture of Certain Bonuses and Profits. Section 304. The Act requires CEOs and CFOs to disgorge bonuses, other incentive- or equity-based compensation and profits where an accounting restatement is required due to material noncompliance of the issuer with any financial reporting requirement under the securities laws as a result of misconduct. This requirement is subject to the exemption authority of the SEC. Effective immediately.

Prohibition of Insider Trades During Pension Fund "Blackout Periods." Section 306(a). This section prohibits executive officers and directors from acquiring or transferring company equity securities during pension fund "black out" periods. "Blackout period" means a period of more than three business days during which trading in a company retirement plan is suspended. Effective by January 26. 2003.

Code of Ethics for Senior Financial Officers. Section 406. The SEC must issue rules requiring each issuer to disclose in periodic reports, whether or not it has adopted a code of ethics for senior financial officers. The SEC must adopt final rules by January 23, 2003.

Officer and Director Bars and Penalties. Section 305 and 1105. In Section 305, the Act gives the SEC the authority to bar an individual from serving as an officer or director of a public company upon a finding that the individual is "unfit" to serve. Section 1105 gives the SEC authority in an administrative cease and desist proceeding to bar an individual who has violated the anti-fraud provisions of the Securities Act and/or the Exchange Act from acting as a director or officer of any public company, if the individual's conduct demonstrates "unfitness" to serve. Effective immediately.

Enhanced Financial Disclosures. Sections 401, 403, 404 and 409. Public companies must provide in periodic reports and other reports filed with the SEC enhanced disclosures in pro forma financial statements and of off-balance sheet transactions (Section 401), include an internal control report in the annual report (Section 404), provide accelerated reporting of certain management purchases and sales of securities (Section 403), and disclose material changes in financial condition or operations **"on a rapid and current basis**"(Section 409). Section 403 is in effect. The SEC must adopt final rules implementing Section 401 by January 26, 2003. Sections 404 and 409 are subject to SEC rulemaking, with no time limit specified.

New Federal Felony. Section 807. The Act creates a new federal felony with a 25 year maximum penalty for defrauding shareholders of publicly traded companies. Effective immediately.

Note: These summaries are not intended to constitute legal advice. Please confer with your legal counsel regarding the provisions of federal and state laws discussed in these summaries.